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Taxes and Tribulations

A Short Comment on State, Capital and Long Term Capital Gains Tax

In this short piece, the author studies the political rhetoric around the revival of long term capital gains tax on the sale of equity shares, as an insight into the relationship between state and capital. This tax was abolished at the turn of the century on the claim that this would boost investment in the capital markets, driving industrial growth. Now, the reversal is premised on the opposite claim: that the absence of tax has driven up speculative investments, away from industrial investment. The author examines this shift, as a telling case of the State attempting to manage capital while facing the condition of financialized capitalism. The author argues that, while the rhetoric broadly makes the correct case: that capital investment must be disciplined in order to spur industrial growth; the rate of taxation belies the promise, and maintains income inequality.

Introduction

As a part of the 2003-04 budget speech, the erstwhile Finance Minister, Mr. Jaswant Singh, noted that in order to "promote investment in the industrial sector" there was a need to boost the capital markets. In order to do so, he proposed, at least for the ensuing year, to abolish capital gains tax on the sale of listed equity shares that had been held for a period of more than one year. Presumably, he meant that the tax exemption would incentivize investment in equity shares of companies involved in industrial production. In the following year, Mr. Chidambaram, presenting the first budget of a new UPA government, drove the same point further when he proposed the removal of capital gains tax on 'long-term capital gains' on all listed securities. Little more can be discerned from the minister's speech, except for the truism – that the tax treatment of capital gains has always been a "vexed issue." Fourteen years hence, in the 2018 budget, the tax on long term capital gains [arising from the sale of equity instruments] was revived. Arun Jaitley, in his budget speech noted, that the tax-free treatment of these gains had resulted in business houses diverting their surplus into financial assets, and therefore, away from productive industry. Reviving this tax, it was suggested, would incentivize investment in 'manufacturing.' This claim is both bold, and interesting, and merits some attention. Before we turn to pay its due, it must however be borne in mind that the minister, almost in a manner of hedging the claim, suggested in the same vein that a vibrant equity market is essential for economic growth. Therefore, he proposed a modest change – a rate of tax of 10% only. Over a period of fourteen years therefore, two, apparently contradictory claims have been made – that a tax on capital gains either promotes productive investment, or diverts from productive investment. I suggest that studying the trajectory of this thought, in a background of the changing nature of the relationship between State and private capital in India will offer some useful insights into the frameworks of economic growth that inform the Indian regulatory landscape.

Capital Markets, Capitalism and Economic Growth:

Given that at the core of our problem is determining the relationship of a 'vibrant' capital market, with industrial growth, some elementary insights into the nature of a capital market must be recalled. Capital markets are a feature of 'finance capitalism' – a stage that is characterized by a separation between finance capitalists (such as lending institutions, or institutional and other investors) and managing capitalists – those who employ the capital in the production process to generate surplus value. As this separation grows, finance capital itself becomes more sophisticated, and financial assets – that represent the relationship between finance and productive capital, such as equity shares or debt instruments – come to be imagined as productive assets in themselves. This may usefully be designated as 'financialized' capitalism; a condition characterized by a vibrant *secondary* market, where investment in financial assets is an activity that does not immediately lead to actual investment in the production process.

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This is a feature of the world we live in – where shares are traded as productive assets in themselves, generating profits. While undoubtedly, they remain linked in some sense, to the underlying production process, this link is so tenuous in the minds of many players in the market, that the price of a traded stock is often purely speculative. In other words, in our modern world, and certainly in its most advanced economies, capital markets are poor indicators of industrial investment. If we were to accept the proposition then, that real growth in industry is the sort of economic growth that a country may aspire to achieve, boosting its capital markets may be only marginally useful to this process. Surely then, Arun Jaitley's claim is an impressive one – that the tax exemption on capital gains, resulted in diversion of investment from productive to speculative capital, against the grain of the wisdom that undergirded the exemption in the first place – that incentivizing capital market investments would in fact help industrial growth.

Made in 2018 however, the claim that a taxation measure would nudge investments from speculation to production is particularly interesting because it invokes an image of the early Indian state forging its relationship with capitalism. At the turn of independence, industrialization was a key priority and the State had its hands full attempting to direct private capital into useful industrial enterprise. Nasir Tyabji, reviewing the efforts of the Nehruvian State in this respect (particularly by amending and enforcing company and tax laws), called this an attempt at social engineering – aimed at converting a class of capitalists who had accumulated wealth in the interwar years through speculation and trading into industrialists. These (entirely legitimate) efforts would come to be viewed, in an ahistoric manner, as interference by the State in the economy resulting in inefficient outcomes, in the run up to liberalization in the 1990s. It is curious then, that several years on, when the orientation of the state-market relationship is decidedly neoliberal, that the government has found it apt to claim, even rhetorically, that it has an interest in managing the direction of private capital investment, away from financial assets into industry. Is it then the case that the government recognizes that the financialized capitalism is unlikely to deliver efficient economic outcomes in a yet *developing* nation? If so, has the government made the case for retaining elements of state control over accumulation processes against the grain of dominant neoliberal political and economic thought?

To Tax or Not to Tax?

As we seek to answer the questions above, it must be borne in mind that the value of a budget speech is often rhetorical. In other words, it might not be the case that the key motivation for reviving the capital gains tax was in fact to direct channels of capital investment. Indeed, the modest tax rate would suggest that the claim may be overstated.

To explore this further, some age old questions of capital gains taxation merit revisiting. At the very outset, theorists of taxation have been divided on the question of whether 'income' made from a capital asset ought to be treated any differently from wages – and based on considerations of equity – several have argued against any difference. Indeed, conservative politicians, when claiming that capital gains must be taxed lightly when compared wage income often admit that to blur the difference is to concede to class warfare. Others, have characterized income from capital gains as being different from wage income in the sense of its disposability; and yet others argue that a high capital gains tax distorts incentives for circulation of capital. None of these are of course, uncontested, but to deal with them in any meaningful detail would be beyond the scope of this essay. Instead, I will turn the attention to a specific set of arguments that surround the tax treatment of capital gains from the sale of *equity* in particular. Often, it has been argued that when the profit from the sale of an equity share is subject to capital gains tax, it amounts to a form of double taxation – because the 'gain' represents nothing more than capitalization of the (already taxed) accumulated earnings of the company. In fact, on this basis, the Kelkar Task Force on direct taxes in 2002, recommended the abolishment of capital gains tax on equity, the year before it was actually abolished, as noted above. Curiously, this basis appeared nowhere in Minster Sinha's budget speech. The argument of course, has been roundly criticized because it is fairly clear that the market value of an equity share does not represent capitalization actual accumulated earnings, but a bet on the possibility of future income of the company. Nonetheless, I intend to pay closer attention to the claim: in my view, the claim illuminates the nature of financialized capitalism, and the role of a corporation in the economy.

It is trite knowledge that a corporation in law, is a legal entity distinct from its shareholders. Economically, it is often viewed as a nexus of contracts, between contributors of capital (shareholders, creditors etc.), labor and functional capitalists (or managers). Each contract determines what the party takes from the company – fixed wages, wages linked to profits, interest, or dividend. The income of the corporation itself, is usually taxed after deducting wages and interest. Dividend however, is distributed from an already taxed remainder – and therefore, the claim is often made with respect to dividend that it ought not to be taxed in the hands of the shareholder as income tax. The claim for exempting capital gains follows from this. The argument would run thus: a gain made from the sale of a share, simply reflects the capitalization of the dividend that may have otherwise accrued to the shareholder (or a future claim on the income of a corporation, should such dividend not be declared).

The problem however is this: even if a corporation were to never declare a dividend, its shares could still be traded for profit eternally, until liquidation, which is an event located in an indistinct future. In other words, a share may be traded for profit without regard to the surplus value extracted from the production process. Trading shares thus, generate income, without generating *value* in the economy – and this forms a legitimate basis for taxation. To deny this, is to deny the separation of *income* from *value*: a claim that is entirely at odds with the condition of financialized capitalism.

Theoretically therefore, there can be no reasonable claim to exempt capital gains from tax; indeed, none for treating such gains any differently from wage income. Yet, even when they are taxed, almost across the world, capital gains are taxed at a lower rate than wage income. This differential treatment is however sought to be justified by a macroeconomic consideration – precisely the one claimed in 2003 by the Finance Minister – that lower taxes on capital gains, boosts capital investment for the purpose of macroeconomic growth. It is not my case that a healthy secondary market in shares does not have any effect in terms of raising capital for actual productive activity. It may very well be the case that companies, in seeking productive capital, can raise such capital by making a public offer of shares; and such public offering is likely to be better subscribed when there already exists an attractive secondary market. But this form of encouragement for accumulating capital gains largely fuels speculative behavior, and in any case, is also palpably inequitable.

Financing Industrial Growth: Whose Money, Whose Profit?

From the above, I think a set of contradictions that affect a State's policy on managing capital gains emerge. If capital market investment is incentivized by removing a capital gains tax, it is likely that the investment in financial assets will be such that no capital will be actually driven into productive enterprise. This, as I noted above, is simply the condition of financialized capitalism. On the other hand, if capital gains are to be taxed like wage income, it could, it is alleged, affect the free circulation of capital – with possible effects on industrial investment. This resistance however is more ideological than being actually linked to any distortionary effects on free enterprise. It is most likely driven by the fact that the people in the highest income bracket earn nearly all their income from capital gains. Therefore, the question of equity, based on the broadly class based differentiation between those who primarily earn through capital gains, and those who earn wages must be considered. It is this third spoke in the policy wheel that I will now turn to in some detail.

While examining this question of equity, it is important to bear in mind that income inequality in India has risen since liberalization, with the top 1% gaining in the first phase of liberalization in 1980s, and the share of the top 0.1% has disproportionately increased since neoliberal changes in the 1990s. To start with, Minister Jaitley noted in his budget speech that the largest part of capital gains generated in the equity market accrued to "corporates and LLPs." This, he asserted, had resulted in a "bias against manufacturing, leading to more *business surplus* being invested in financial assets" (emphasis mine). Read together, the claim appears to be this: that companies that are otherwise engaged in productive business have invested their profits in stock trading rather than in industry, and the tax ought to correct for this behavior. There can be no quibble with the premise that the maximum investment activity in the capital markets is by 'corporates and LLPs', but productive corporations to whom the statements apply is only a small subset of this aggregated mass. The bulk of corporations playing in the capital markets are in fact those which exist solely to invest, including a variety of financial institutions, other institutional investors (like a private equity firm), mutual funds and the like. The tax may play on the incentives of these institutional investors, and on retail investors - a category of individuals who either directly invest in the capital markets, or do so through equity linked mutual funds and other such schemes. Without robust information on how these institutional investors or retail investors actually invest, the claim that the tax would in fact rework the balance between speculative and productive investment is clearly overstated. Taxation is ultimately dictated by the government's interest to shore up its revenue. Given the significant expansion in participation in equity markets, including through mutual funds (tremendously advertised as the "right" thing to do), taxing long-term capital gains is a naturally attractive tax base. To couch a justification for this, along the lines of helping industrial growth however, is rather stretched. Given the rate of taxation has been fixed at 10%, which matches the first progressive tax bracket for income tax, small retail investors are likely to divert their savings to options outside the equity market. If retail investor participation in the capital markets is an indicator of capital being 'democratized' in any sense, gnawing at traditional class lines, this tax will surely roll back that process. On the other hand, the extent to which this rate may alter incentives for institutional investors remains entirely unclear. The comparatively lower rate of capital gains tax on equity will however, continue to incentivize the top earners to convert their earnings from corporations into capital gains rather than remuneration: a trend that has been observed in correlation with rising income inequality in the US.

Conclusion

From the above, it is fairly evident that the manner in which the long-term capital gains tax has been revived throws a wide schism between political rhetoric, reasonable economics and considerations of equity into sharp relief. As pointed out, Minister Jaitley made two explicit claims: first, that the tax will likely boost industrial investment as opposed speculation; second, that at the same time, the tax ought to be low enough to keep capital markets buoyant. Also, by pointing to "corporates" being the primary gainers in the capital markets, he appears to make an implicit claim of equity – given that wage earners are subject to income tax, it would only be fair to tax capital gains. This implicit claim however is undercut simply by the low rate of tax, coupled with the fact that it would only serve to lower incentives for individuals from investing in capital markets. So far as the explicit claims go – the second, as I argued above is deeply contestable, given the stage of capitalist development that we are in. If anything it serves to blunt the first claim, which I began by noting is impressive. Despite the attractiveness of the claim, absent much information on the investment behavior of manufacturing/industrial companies, coupled with a low rate of capital gains taxation, it remains to be seen if money actually ends up flowing away from speculative investments to productive activity, and here, my view remains bleak.

End Notes

1 Profit from the sale of a listed security is classified as 'long-term capital gain', when the security has been held for a period longer than one year

2 See generally, Mary Mellor, The Future of Money: From Financial Crisis to Public Resource 84-86 (Pluto Press, 2010)

3 Nasir Tyabji, Forging Capitalism in Nehru's India: Neocolonialism and the State, c. 1940-1970 (2015)

4 Leonard E. Burman, The Labyrinth of Capital Gains Tax Policy: A Guide for the Perplexed (Brookings, 1999).

5 See Shankar Acharya, Thirty Years of Tax Reform in India, *Economic and Political Weekly* 2005, 40(20): 2061-70.

6 See generally, Michael C. Jensen & William H. Meckling, The Theory of Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics,* 1976, 3: 305.

7 Thomas Piketty, Emmanuel Saez, Gabriel Zucman, Distributional National Accounts: Methods and Estimates for the United States, *NBER Working Paper 22945* (December 2016).

8 Abhijit Banerjee and Thomas Piketty, Top Indian Incomes, 1922-2000, *The World Bank Economic Review* 19(1): 1.

9 Counter-intuitively, at least one survey appears to indicate that retail investors may prefer to invest directly in equity rather than through mutual funds – See, https://economictimes.indiatimes.com/wealth/invest/83-retail-investors-invest-directly-in-stocks-only-57-invest-in-mfs-survey/articleshow/59818974.cms (last visited on 22 Feb., 2018).

10 See Piketty, Saez & Zuckman, supra note 7.

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O.P. Jindal Global University (JGU) is a non-profit global university established by the Government of Haryana and recognised by the University Grants Commission (UGC). JGU was established as a philanthropic initiative of its Founding Chancellor, Mr. Naveen Jindal in memory of his father, Mr. O.P. Jindal. JGU has been awarded the highest grade 'A' by the National Accreditation & Assessment Council (NAAC). JGU is one of the few universities in Asia that maintains a 1:13 faculty-student ratio and appoints faculty members from India and different parts of the world with outstanding academic qualifications and experience.

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